DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

200243054

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

UIL: 72.05-01

JUL 31 2002

Attention:

T:EP:RA:T1

Legend:

Employer M.....

Plan X.....

Plan Y.....

Dear :

This is in response to a letter dated April 20, 2001, as supplemented by correspondence dated September 26, 2001, October 18, 2001, May 6, 2002, May 29, 2002, June 18, 2002, and June 25, 2002, submitted on your behalf by your authorized representative regarding rulings under section 72 of the Internal Revenue Code (the "Code"). The following facts and representations were submitted in connection with your request.

Employer M maintains Plan X and Plan Y for the benefit of its employees and employees of its affiliates. Plan X is a profit-sharing plan under Code section 401(a) which includes a cash or deferred arrangement under section 401(k). Plan X's most recent favorable determination letter from the Internal Revenue Service is dated May 12, 1997.

Plan X provides for elective deferrals, after-tax contributions, and matching contributions. In addition, participants may make rollover contributions to Plan X, and prior to January 1, 1987, Plan X permitted qualified voluntary employee contributions deductible under Code section 219 ("QVECs"). Under section 7.2 of Plan X, an individual Plan account is established on behalf of each participant under which a separate sub-account is maintained for each of the above types of contributions that are made to the Plan on a participant's behalf. You represent that earnings, gains, losses, distributions, and other credits and charges are allocated to each sub-account on a reasonable and consistent basis. Each participant's account is split into two separate contracts for purposes of applying the basis recovery rules under Code section 72: one contract consists of all after-tax contributions and income allocable

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thereto ("Separate Contract"), and the other consists of all other amounts held under the Plan (the "Principal Contract").

Under section 6.1 of Plan X, a participant who retires on or after his Retirement Date under the plan ("Retired Participant") may elect to receive a distribution of his account in either a lump sum or installments over a 5, 10, 15, 20, 25, or 30 year period. Retired Participants may also elect to make withdrawals under Options 2, 3, 4, and 6 of section 6.5 of Plan X. Retired participants electing a withdrawal under these options may or may not be receiving installment payments pursuant to section 6.1 of Plan X.

Under section 6.2 of Plan X, a participant who terminates employment for reasons other than death or retirement on or after his Retirement Date under the plan may only elect a lump sum distribution or withdrawals under Options 2, 3, and 4 of section 6.5 of Plan X. Participants who are current employees of Employer M are also eligible for withdrawals under Options 1 through 5 of section 6.5.

Under Option 1 of section 6.5 of Plan X, a participant who is actively employed by Employer M and under the age of 59 ½ may elect to make a regular withdrawal from Plan X. These withdrawals are made in the following order:

(i) the amount of the participant's after-tax contributions (or the value of such contributions, if lower), as of the date of distribution that were deposited in Plan X prior to January 1, 1987, except that such amount shall not exceed the participant's investment in the contract (as defined under Code section 72) under Plan X as of December 31, 1986;

(ii) pro rata from the participant's after-tax contributions made on or after January 1, 1987, and net earnings on all after-tax contributions (both pre-1987 and post-1986) allocated to the participant's account;

(iii) the amount of the participant's vested matching contributions plus net earnings on such amount; provided that if the participant has not terminated employment with Employer M and any affiliate, no amount may be withdrawn under this subparagraph (iii) which is attributable to matching contributions made to Plan X within 24 months prior to the date of the withdrawal (the "Holding Period") (effective for withdrawals made after the date the Internal Revenue Service issues a favorable determination letter approving the elimination of the Holding Period, the Holding Period requirement shall not apply);

(iv) the amounts attributable to the participant's rollover contributions; and

(v) the amounts attributable to the participant's QVECs.

Under Option 2, participants who either attain age 59 ½ or terminate employment may make a special withdrawal which is made in the same order as the withdrawals

under Option 1 except that the subparagraph (iv) consists of elective deferrals and net earnings thereon and subparagraphs (iv) and (v) become subparagraphs (v) and (vi), respectively. Retired Participants who are receiving installment payments are eligible to make a special withdrawal under Option 2. Option 3 provides for withdrawals of rollover contributions, and Option 4 permits withdrawals of QVECs. Under Option 5, hardship withdrawals of non-qualified matching contributions and elective deferrals are allowed provided that the amounts available for withdrawal under Option 1 or Option 2, whichever is applicable, have been previously withdrawn. Plan X permitted in-service withdrawals of after-tax contributions similar to Option 1 (i.e., prior to separation from service) on May 5, 1986.

A new Option 6 will be added to section 6.5 of Plan X which will become effective on or about July 1, 2003. Option 6 will permit a Retired Participant to elect to make a direct rollover of an eligible rollover distribution from Plan X to Plan Y. Retired Participants who are receiving installment payments from Plan X will be eligible for Option 6 only if they elect to receive their entire remaining account balance under Plan X. The actual amount that will be available for rollover under Option 6 is limited to the vested portion of the participant's entire account balance other than the portion attributable to after-tax contributions. Distributions under Option 6 will be made in the following order:

(i) the vested portion of the participant's account balance under the Principal Contract;

(ii) pre-1987 after-tax contributions; and

(iii) pro rata from post-1986 after-tax contributions and earnings on all after-tax contributions.

Based on the above facts and representations, you request the following rulings that:

(1) the sub-account under Plan X consisting of after-tax contributions and any income allocable thereto will constitute a separate contract under Code section 72(d)(2), and

(2) Plan X's specification of the sub-accounts from which withdrawals are made under section 6.5 of Plan X will be recognized for purposes of Code section 72 in determining the taxability of these withdrawals.

Regarding ruling request (1), Code section 402(a)(1) provides generally that any amount actually distributed to a distributee by an employees' trust described in section 401(a) and exempt from tax under section 501(a) is taxable to the distributee, in the taxable year of the distribution, under section 72.

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Code section 72(d)(2) provides that employee contributions (and the income allocable thereto) under a defined contribution plan may be treated as a separate contract for purposes of applying section 72.

Notice 87-13, 1987-1 C.B. 432 ("Notice 87-13") provides that in order for a contract to be recognized as a separate contract, a plan (or plan procedures) must either specify the contract from which distributions are to be made or permit participants to do so. A distribution will be treated as having been made under the separate contract to the extent that the plan charges the distribution against such contract (or the accounts that constitute such contract for plan accounting purposes). See Q&A-14 of Notice 87-13.

Plan X is a defined contribution plan that permits employee contributions. Options 1 through 6 in section 6.5 of Plan X specify from which contract, Principal or Separate, the withdrawals are made. Under section 7.2 of Plan X, these withdrawals are charged against the sub-accounts of a participant's individual account that constitute the Separate Contract as well as the Principal Contract under the plan. Accordingly, we conclude with respect to ruling request (1) that the Separate Contract and Principal Contract are considered separate contracts under Code section 72(d)(2) and Notice 87-13 for purposes of applying the provisions of section 72.

Regarding ruling request (2), Code section 72 provides rules regarding the taxability of distributions that are "amounts received as an annuity" (under section 72(d)(1)) and "amounts not received as an annuity" (under section 72(e)) from a plan qualified under section 401(a).

Section 1.72-1(b) of the federal Income Tax Regulations (the "regulations") generally defines "amounts received as an annuity" as amounts that are payable at regular intervals over a period of more than one full year from the date on which they are deemed to begin, provided the total of the amounts so payable or the period for which they are to be paid can be determined as of that date. Any other amounts to which Code section 72 applies are "amounts not received as an annuity."

Section 1.72-2(b)(2)(iii) of the regulations further defines "amounts received as an annuity" by providing that the total of the amounts payable must be determinable at the annuity starting date either directly from the terms of the contract or indirectly by the use of mortality tables or compound interest computations, or both, in accordance with the terms of the contract and sound actuarial principles.

Section 1.72-2(b)(3)(i)(a) of the regulations provides that notwithstanding the definition of "amounts received as an annuity" under section 1.72-2(b)(2), if amounts are to be received for a definite or determinable time under a contract which provides that the amounts of the periodic payments may vary in accordance with investment experience, cost of living indices, or similar fluctuating criteria, each such payment received shall be considered, to the extent enumerated therein, as an amount received as an annuity.

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If an amount not received as an annuity is received before the annuity starting date, Code sections 72(e)(5) and 72(e)(8) provide that, in the case of a qualified plan which on May 5, 1986, permitted withdrawal of employee contributions before separation from service, such amount is includible in gross income only to the extent it (when added to amounts previously received under the contract after December 31, 1986 that were excludable from gross income on account of section 72(e)(8)(D)) exceeds the employee's investment in the contract on December 31, 1986. Section 72(e)(8)(B) imposes a pro-rata basis recovery rule with respect to post-1986 after-tax contributions and the earnings on all after-tax contributions.

Section 1.72-4(b) of the regulations generally defines the term "annuity starting date" as the first day of the first period for which an amount is received as an annuity.

As indicated above, it is necessary to determine whether the withdrawals under Options 1 through 6 of section 6.5 of Plan X meet the definition of "amounts received as an annuity." Under Options 1, 2, and 5, withdrawals are first treated as being made from the Separate Contract. Within the Separate Contract, withdrawals are first made from pre-1987 after-tax contributions, and then pro rata from post-1986 after-tax contributions and the earnings on all after-tax contributions. After these amounts are exhausted, amounts are treated as withdrawn from specific sub-accounts of the Principal Contract, which is comprised solely of taxable amounts. Under Options 3 and 4, only amounts attributable to rollover contributions and QVECs, respectively, are permitted to be withdrawn. Option 6 will permit withdrawals first from the vested portion of the Principal Contract, and then from the Separate Contract. Within the Separate Contract, under Option 6, withdrawals will then be taken first from pre-1987 after-tax contributions, and then pro rata from post-1986 after-tax contributions and the earnings on all after-tax contributions.

Pursuant to section 1.72-1(b) of the regulations, the withdrawals that may be made under Options 1 through 6 are not considered "amounts received as an annuity" since they are not payable at regular intervals over a period of more than one full year, and neither the total amounts payable nor the total period for which payments are to be made can be determined as of the date they are deemed to begin. Similarly, installments payments received by Retired Participants under section 6.1 of Plan X are not considered "amounts received as an annuity," because neither the total amounts payable nor the total period for which payments are to be made can be determined as of the date they are deemed to begin. There can be fluctuations in the account balances of Retired Participants that are not related to investment experience. First, a Retired Participant receiving installment payments may make withdrawals in such amounts as he may desire under Options 2, 3, and 4. Secondly, a Retired Participant receiving installment payments may elect to withdraw his entire remaining account balance in order to make a direct rollover under Option 6. Because the installment payments and withdrawals under Plan X are not "amounts received as an annuity," they constitute "amounts not received as an annuity."

As for whether the amounts not received as an annuity are to be treated under Code section 72(e) as received before the annuity starting date, the only distributions available under Plan X are installment payments, lump sum distributions, or withdrawals under Options 1 through 6. The installment payments and withdrawal amounts under Plan X are "amounts not received as an annuity." Because these amounts are not received as an annuity, there is no annuity provided under Plan X, and thus these distributions could not be made after an annuity starting date. These distributions, therefore, are treated under section 72(e) as "amounts received before the annuity starting date." Accordingly, section 72(e) applies to all of the withdrawals under Options 1 through 6 and installment payments under Plan X. Because Plan X provided in-service withdrawals of employee contributions on May 5, 1986, section 72(e)(8)(D) applies for determining the taxability of installment payments and the withdrawals from the Separate Contract under Options 1, 2, 5 and 6. Accordingly, we conclude with respect to ruling request (2) that Plan X's specification of the sub-accounts from which withdrawals are made under section 6.5 of Plan X, will be recognized for purposes of Code section 72 in determining the taxability of these withdrawals. Furthermore, installment payments received under Plan X are also amounts not received as an annuity and received before the annuity starting date. These payments are similarly subject to section 72(e)(8)(D).

The above rulings are based on the assumption that Plan X is qualified under Code section 401(a) and that its related trust is tax exempt under section 501(a) at all relevant times.

This ruling is directed only to the taxpayer that requested it. Code section 6110(k)(3) provides that it may not be used or cited by others as precedent.

Pursuant to a power of attorney on file with this office, copies of this letter have been sent to your authorized representatives.

Should you have any concerns regarding this ruling request, please contact .

Sincerely yours,

Andrew E. Zuckerman

Andrew E. Zuckerman, Manager
Employee Plans Technical Group 1
Tax Exempt and Government Entities Division

cc:

Enclosures:
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